INTERNAL CONTROLS

SCOPE

An internal control system is critical to an entity (agency, division, department, program) for keeping on course in achieving its organizational objectives. This chapter is designed to acquaint agency personnel with the importance of internal control in their day-to-day operations. At http://myshare.in.gov/sba/encompass, in the Internal Controls folder, the Internal Control Guide for Managers *for the State of Indiana gives further guidance to management for establishing controls within the entity.*

2.1 STATUTORY AUTHORITY

Authority is given to the Office of Management and Budget to require an internal control system to be established and maintained in state agencies and instrumentalities in these statutes.

*IC 4-3-22-14**, Agencies and instrumentalities; required compliance and cooperation,** states:*
"All instrumentalities, agencies, authorities, boards, commissions, and officers of the executive, including the administrative department of state government, and all bodies corporate and politic established as instrumentalities of the state shall: (1) comply with the policies and procedures related to fiscal management that are established by the OMB and approved by the governor; and (2) cooperate with and provide assistance to the OMB."

*IC 4-3-22-15**, Agencies; accountability; compliance with statutory requirements,** states:*
"All state agencies (as defined in IC 4-12-1-2) shall, in addition to complying with all statutory duties applicable to state purchasing, be accountable to the OMB for adherence to policies, procedures, and spending controls established by the OMB and approved by the governor."

2.2 WHY REQUIRE INTERNAL CONTROLS?

2.2.1 Good Management Practice

Our state agencies exist to achieve a mission and accomplish certain goals and objectives. The overall purpose of internal control is to help each department achieve its mission. An effective internal control system helps an agency (or department) to:

- *Promote orderly, economical, efficient and effective operations*
- *Produce quality products and services consistent with the department's mission*
- *Safeguard resources against loss due to waste, abuse, mismanagement, errors and fraud*
- *Promote adherence to statutes, regulations, bulletins and procedures*
- *Develop and maintain reliable financial and management data, and accurately report that data in a timely manner*

2.2.2 Ensure Performance

Internal control is the integration of the activities, plans, attitudes, policies, and efforts of the people of an agency/department working together to provide reasonable assurance that the agency/department will achieve its mission. Part of the mission of the agency/department is always to operate as efficiently and effectively as possible, ensuring the best use of the taxpayers' money.

2.2.3 Increase Accountability

Public sector managers are responsible for managing the resources entrusted to them to *administer government programs. A major factor in fulfilling this responsibility is ensuring that adequate controls exist. Public officials, legislators, and taxpayers are entitled to know whether government agencies are properly administering funds and complying with laws and regulations. They need to know whether government organizations, programs, and services are achieving the purposes for which they were authorized and intended***.**

Officials and employees who manage programs must be accountable to the public. Frequently specified by statute, this concept of accountability is intrinsic to the governing process of our state.

2.2.4 Safeguard Scarce Resources

Management should protect the department's equipment, information, documents and other resources that could be wrongfully used, damaged or stolen by limiting access to authorized individuals only and by instituting adequate controls and approvals.

2.2.5 Deter Fraud and Abuse

Most cases of fraud in governmental units is a direct result of a lack of internal control in the agency/department. An employee with too much access to certain systems and no oversight can divert valuable resources, such as cash, to sources outside the government, thus committing fraud.

2.2.6 Meet Legal Requirements

Programs administered by governmental units are subject to a wide array of laws, regulations, and required procedures. A well maintained internal control system will help to insure that applicable requirements are followed.

2.3 COMPONENTS OF INTERNAL CONTROL

2.3.1 Standard #1: Control Environment

Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management. The following affect the Control Environment.

2.3.1.1 Integrity and Ethical Values

A responsibility of management is to establish and communicate the ethical values of an agency/department. However, it is everyone's responsibility to demonstrate integrity by adhering to those ethical values.

2.3.1.2 Commitment to Competence

Although management is responsible for hiring staff with adequate competencies to perform duties required, it is the employee's responsibility to perform up to his/her level of competency.

2.3.1.3 Management's Philosophy and Operating Style

This factor determines the degree of risk the entity is willing to take and management's philosophy towards performance-based management. The attitude of management toward reporting, *information technology and accounting functions, and responsiveness to audits and evaluations play a big part in this component.*

2.3.1.4 Organizational Structure

Management's framework for planning, leading and controlling operations to achieve the entity's objectives should define key areas of authority/responsibility and establish lines of reporting. Policies must be communicated to ensure that staff members are aware of their duties and responsibilities, understand how their individual actions interrelate and contribute to the department's objectives, and recognize how and for what they will be held accountable.

2.3.1.5 Assignment of Authority and Responsibility

The assignment of authority and responsibility, thus making individuals accountable for their performance, affects the initiative of employees. Such increased delegation may require higher employee competency and a different style of ***Monitoring.***

2.3.1.6 Human Resource Policies and Practices

Through human resource policies and practices, management communicates its expected levels of integrity, ethical behavior, and competence. Hiring practices, orientation, training, evaluation, counseling, promoting, compensating, and remedial actions influence the ***Control Environment****.*

2.3.2 Standard #2: Risk Assessment

Risk Assessment *is the identification, analysis, and management of risks relevant to the achievement of the department's goals and objectives. Risks include internal and external events or circumstances that may occur and adversely affect operations. Once risks are identified, management should consider their impact (or significance), the likelihood of their occurrence, and how to manage them.*

2.3.2.1 Risk Identification

Two circumstance, ***change*** *and* ***inherent risk,*** *are most likely to threaten the achievement of objectives. Some examples of change that must be closely monitored, are:*

- *Personnel changes*
- *Regulatory changes*
- *New information systems and technology*
- *New programs or services; expansion of operations*
- *Reorganizations with or between departments*

Examples of ***inherent risk*** *(due to the nature of the process)****:***

- *Loss from fraud, waster, unauthorized use, or misappropriation – ex. Loss of cash*
- *Complexity of a program or activity*

- *Third part beneficiaries attempt to obtain benefits for unrendered services*
- *Prior record of control weakness; failure to remedy control weakness identified by auditors*

2.3.2.2 Risk Analysis

After risks are identified, they need to be evaluated in terms of:

- ***Likelihood -**The probability that the unfavorable event would occur if there were no (or limited) internal controls to prevent or reduce the risk.*
- ***Impact (or Significance) -**A measure of the magnitude of the effect to a department if the unfavorable event were to occur.*

2.3.2.3 Risk Management

*Managers use **Risk Assessments** to determine the relative potential for loss in programs and functions and to design the most cost-effective and productive internal controls. Using these guidelines and the **Risk Assessment** information, managers should then determine whether to:*

- ***Accept the risk:*** *Do not establish Control Activities*
- ***Prevent or reduce the risk:*** *Establish Control Activities*
- ***Avoid the risk (if possible):*** *Do not carry out the function*

***Risk Assessment** can serve management in two directions. Operations improve because risk assessment assumes sound planning and the systematic setting of objectives. Internal control within the management control system is strengthened as activities are evaluated for risk. In the process, an agency is likely to improve both its services and its public image.*

2.3.3 Standard #3: Control Activities

***Control Activities** are tools - policies, procedures, techniques, and mechanisms - that help identify, prevent or reduce the risks that can impede accomplishment of the department's objectives. They are essential for proper stewardship and accountability of government resources and for achieving effective and efficient program results.*

*Many different **Control Activities** can be used to counter the risks that threaten a department's success. Most **Control Activities**, however, can be grouped into two categories:*

- ***Prevention** activities are designed to deter the occurrence of an undesirable event. The development of these controls involves predicting potential problems before they occur and implementing ways to avoid them.*
- ***Detection** activities are designed to identify undesirable events that do occur, and alert management about what has happened. This enables management to take corrective action promptly.*

2.3.3.1 Documentation

*Documentation of **transactions** should enable managers to trace each transaction from its inception through its completion. This means the entire life cycle of the transaction should be recorded, including: (1) its initiation and authorization; (2) its progress through all stages of processing; and (3) its final classification in summary records.*

*Documentation of **policies and procedures** is critical to the daily operations of a department. These documents set forth the fundamental framework and the underlying methods and processes all employees rely on to do their jobs. They provide specific direction to and help form the basis for decisions made every day by employees. Without this framework of understanding by employees, conflict can occur, poor decisions can be made, and serious harm can be done to the department's reputation. Further, the efficiency and effectiveness of operations can be adversely affected.*

2.3.3.2 Approval and Authorization

Approval and authorization is the confirmation or sanction of employee decisions, events or transactions based on a review. Management should determine which items require approval based on the level of risk to the department without such approval. Management should clearly document its approval requirements and ensure that employees obtain approvals in all situations where management has decided they are necessary.

Authorization is the power management grants employees to carry out certain duties, based on approval received from supervisors. Authorization is a control activity designed to ensure events or transactions are initiated and executed by those designated by management. Management should ensure that the conditions and terms of authorizations are clearly documented and communicated, and that significant transactions are approved and executed only by persons acting within the scope of their authority.

2.3.3.3 Verification/Reconciliation

Verification (or reconciliation) is the determination of the completeness, accuracy, authenticity and/or validity of transactions, events or information. It is a control activity that enables management to ensure activities are being performed in accordance with directives.

The list below offers some examples of verification and reconciliation.

- *Reviewing vendor invoices for accuracy by comparing to purchase orders and contracts.*
- *Comparing cash receipts transactions to a cash receipts log and tracing to bank deposit records.*
- *Reviewing and verifying a participant's eligibility for State program services.*
- *Reconciling a department's cash records to bank statements or other required records.*

2.3.3.4 Separation of Duties

Separation of duties is the division or segregation of key duties and responsibilities among different people to reduce the opportunities for any individual to be in a position to commit and conceal errors, intentional or unintentional, or perpetrate fraud in the normal course of their duties. The *fundamental premise of segregated duties is that different personnel should perform the functions of initiation, authorization, record keeping, and custody. No one individual should control or perform all key aspects of a transaction or event. These are called incompatible duties when performed by the same individual. The following are examples of incompatible duties.*

- *Individuals responsible for data entry of payment vouchers should not be responsible for approving these documents.*
- *Individuals responsible for acknowledging the receipt of goods or services should not also be responsible for purchasing approvals or payment activities.*
- *Managers should review and approve payroll expenses and time sheets before data entry, but should not be involved in preparing payroll transactions.*
- *Individuals performing physical inventory counts should not be involved in maintaining inventory records nor authorize withdrawals of items maintained in inventory.*
- *Individuals receiving cash into the office should not be involved in recording bank deposits in the accounting records.*
- *Individuals receiving revenue or making deposits should not be involved in reconciling the bank accounts.*

2.3.3.5 Safeguarding of Assets

Safeguarding of assets *involves restricting access to resources and information to help reduce the risk of unauthorized use or loss. Management should decide which resources should be safeguarded and to what extent, making these decisions based on the vulnerability of the items being secured and the likelihood of loss.*

2.3.3.6 Supervision

Supervision is the ongoing oversight, management and guidance of an activity by designated employees to help ensure the results of the activity achieve the established objectives. Those with the responsibility for supervision should:

- Assign tasks and establish written procedures for completing assignments.
- Systematically review each staff member's work.
- Approve work at critical points to ensure quality and accuracy.
- Provide guidance and training when necessary.
- Provide documentation of supervision and review (for example, initialing examined work).

2.3.3.7 Reporting

Effective and accurate reporting is a means of conveying information. It serves as a control when it provides information on issues such as timely achievement of goals, financial position and employee concerns. Reporting also helps to promote accountability for actions and decisions. The list below offers *some examples of effective and accurate reporting.*

- *Project status reports to alert management to potential cost or time overruns.*
- *Reports to monitor employee leave balances, position vacancies and staff turnover to determine effectiveness of workplace and employment practices.*
- *The State's Comprehensive Annual Financial Report (CAFR) issued for the public's review of Indiana's financial performance and position.*
- *Various financial and progress reports required by federal and other grantors.*

2.3.4 Standard #4: Communication and Information

Information should be recorded and communicated to management and others within the organization who need it and in a form and within a time frame that enables them to carry out their Internal Control Activities and other responsibilities.

2.4.4.1 Information

Managers need operational and financial data to determine whether they are meeting their department's strategic and annual performance plans and if they are meeting their goals of accountability for effective and efficient use of resources. Effective management of information technology is critical to achieving useful, reliable, and accurate recording and communication of information.

2.4.4.2 Communication

Effective communications should occur in a broad sense with information flowing down, across, and up the department. Management should establish communication channels that:

- *Provide timely information.*
- *Inform employees of their duties and responsibilities.*
- *Enable the reporting of sensitive matters, including fraudulent or unethical behaviors.*
- *Enable employees to provide suggestions for improvement.*
- *Provide the information necessary for all employees to carry out their responsibilities effectively.*
- *Convey top management's message that internal control responsibilities are important and should be taken seriously.*
- *Convey and enable communication with external parties.*

2.3.5 Standard #5: Monitoring

Monitoring is the review of the organization's activities and transactions to assess the quality of performance over time and to determine whether controls are effective.

2.3.5.1 Focus Areas

*The **Monitoring** performed by a department should focus on the following major areas.*

- *Control Activities*
- *Mission*
- *Control Environment*
- *Communication*
- *Risks and Opportunities*

2.3.5.2 Internal Evaluations

*Controls need to be monitored for effectiveness ("Are they are operating as intended?") and to ensure they have not become obsolete. Separate evaluations of **Control Activities** can also be useful by focusing directly on the controls' effectiveness at a specific time.*

2.3.5.3 Audit Resolution

***Monitoring** of internal control should include policies and procedures for ensuring that the findings of audits and other reviews are promptly resolved. Managers are to (1) promptly evaluate findings from audits and other reviews, including those showing deficiencies and recommendations reported by auditors and others who evaluate the department's operations; (2) determine proper actions in response to findings and recommendations from audits and reviews; and (3) complete, within established timeframes, all actions that correct or otherwise resolve the matters brought to management's attention. The resolution process begins when audit or other review results are reported to management and is completed only after action has been taken that corrects identified deficiencies, produces improvements, or demonstrates that findings and recommendations do not warrant management action.*

2.4 FINANCIAL SYSTEM CONTROL ACTIVITIES

*Internal Control **Standard #3, Control Activities** (section 2.3.4), have been applied to the ENCOMPASS financial accounting system by the use of "roles" with limited access to the system. Prior to the implementation of ENCOMPASS, a user might have been able to perform incompatible duties such as described in section 2.3.4.4. Now, users are not given roles that might enable them to both enter and approve a transaction. In the event that incompatible roles may inadvertently be present, the "entry vs. approval" roles are constantly reviewed and changes made when necessary. After agency entry and approval, most transactions are then routed to an Auditor of State (AOS) approver for an additional review.*

It is critical that an agency approver, whether it be approval of a deposit, payment, journal entry or asset entry, be cognizant of the various funds, accounts, departments and programs of his/her agency in order that incorrect entries be returned to the entry staff for correction prior to approval. It is not the responsibility of the AOS staff to be aware of all operations within an agency and how they should be recorded.

A list of ENCOMPASS roles, and the definition of each, is included in the Appendices at the end of this chapter.

2.5 LIMITATIONS OF INTERNAL CONTROL

Internal controls, no matter how well designed and operated, provide only reasonable assurance to management regarding the achievement of a department's objectives. Certain limitations are inherent in all internal control systems. Despite these limitations, the reasonable assurance that internal control does provide enables a department to focus on reaching its objectives while minimizing undesirable events.

2.5.1 Costs vs. Benefits

Prohibitive cost can prevent management from installing the ideal internal control system. Management will occasionally accept certain risks because the cost of preventing such risks cannot be justified. Furthermore, ***more control activities are not necessarily better*** *in an effective internal control system. Not only can the cost of excessive or redundant controls exceed the benefits, but this may also affect staff's perceptions on controls. If they consider internal controls as obstructions to work processes or "red tape", this negative view could adversely affect their overall regard for internal controls.*

2.5.2 Judgment

The effectiveness of an internal control system is limited by the realities of human weakness in making decisions. Decisions must often be made under the pressures of time constraints, based on limited information at hand, and relying on human judgment. Additionally, management may fail to anticipate certain risks and thus fail to design and implement appropriate controls.

2.5.3 Breakdowns

Well-designed internal control systems can break down. Personnel may misunderstand instructions or make errors in judgment, or they may commit errors due to carelessness, distraction, or fatigue.

2.5.4 Collusion

The collusive activities of two or more individuals can result in internal control failures. Individuals acting collectively to perpetrate and conceal an action from detection often can alter financial data or other management information in a manner that circumvents control activities and not be identified by the system of internal control.

2.5.5 Management Override

An internal control system can only be as effective as the people who are responsible for its functioning. Management has the capability to override the system. "Management override" means overruling or circumventing prescribed policies or procedures for illegitimate purposes – such as personal *gain or an enhanced presentation of a department's financial condition or compliance status. Management override should not be confused with "management intervention", which represents management's actions to depart from prescribed policies or procedures for legitimate purposes. Management intervention is necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled inappropriately.*

2.6 Appendices

2.6.1 ENCOMPASS ROLES

NOTE: THIS SECTION UNDER CONSTRUCTION; TO BE ADDED AT A LATER DATE